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## **AGENDA ITEM 8a**

### **TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Credit Enhancement Program Annual Review
- II. PROGRAM:** Credit Enhancement Program
- III. RECOMMENDATION:** Information Item – Annual Review
- IV. ANALYSIS:**

**Program Background:** The CalPERS Board approved a nationwide Credit Enhancement Program (CEP) with an initial commitment of \$5 billion on February 18<sup>th</sup>, 2003. The Board subsequently approved the Investment Policy Guidelines for CEP in September of 2003. CalPERS CEP received the highest long term ratings from both Moody's Investor Services and Fitch Ratings in December of 2004 and received the highest short term rating of A1+ from S&P in January of 2007. All ratings have remained stable since the rating assignments.

In June 2008, CalPERS Board approved an amendment to the CEP policy which increased the total aggregate commitment amount from \$5 billion to \$10 billion.

**Program Summary:** During the reporting period which ended 12/31/08, staff underwrote approximately \$748 million in new commitments bringing the total program outstanding commitment balance to \$2.3 billion. The CEP has generated \$3.9 million in net earnings over the current reporting period versus \$2.0 million in the previous reporting period. (Please refer to Attachment 1 for Wilshire's review.) The increase in program revenue is the result of better pricing for new transactions combined with a higher level of overall program commitments. (Please refer to Table 1 for a breakout of program commitments.)

**Table 1. Program Commitments**

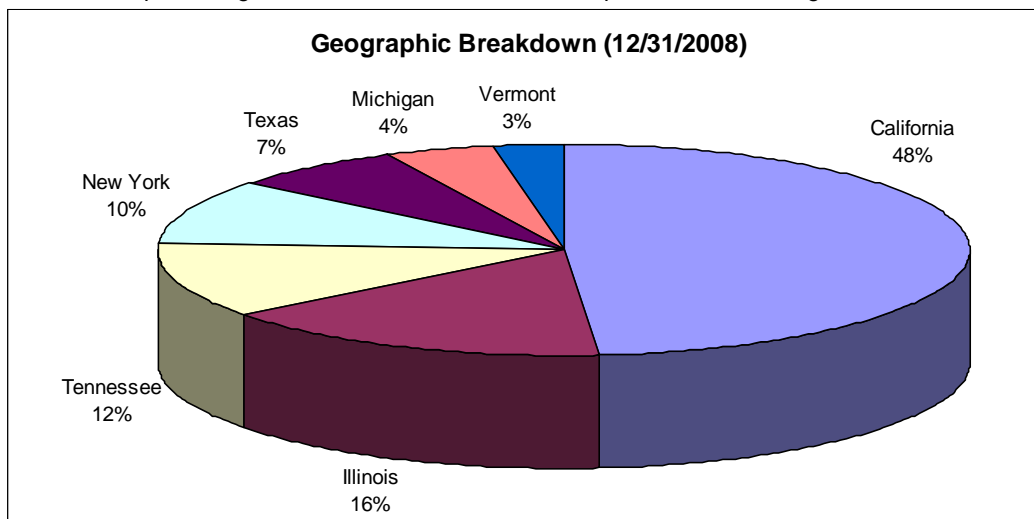
Security Description	Total Commitment	Sector
CA Dept of Water Resources ser 2002	75,000,000	Electric Utility
CA Dept of Water Resources ser 2005	75,904,110	Electric Utility
City of New York ser I	75,647,260	Municipality
City of New York ser H	142,723,601	Municipality
Michigan State Building Authority ser 2003	100,000,000	State
State of California ser 2003	75,000,000	State
Texas Transportation Commission ser 2006	75,863,014	State
Vermont Student Assistance Corp ser 2005	64,051,416	Student Loans
LA Department of Water Resources ser 2001	151,676,712	Public Power
UC Regents Medical Center ser 2007	24,307,457	Higher Education
SMUD CP ser 2007	51,232,877	Electric Utility
San Antonio CPS Energy CP ser 2007	75,000,000	Electric Utility
State of California CP ser 2007	256,780,822	State
Nashville & Davidson County CP ser 2007	133,990,868	County
TN State School Bond Authority CP ser 2007	126,914,063	Higher Education
South Placer Waste Water Authority ser 2008	41,800,585	Water and Waste Water
CA Dept of Water Resources ser 2008	81,315,069	Electric Utility
Bay Area Toll Authority ser 01-06	252,794,521	Infrastructure/Bridge
Bay Area Toll Authority ser 2008 A-1	27,000,000	Infrastructure/Bridge
City of Chicago Water System ser 2004	354,027,397	Water and Waste Water

In terms of geographic distribution, the Program's top three exposures by state are California, Illinois, and Tennessee which represent 48%, 16%, and 12% of the total Program commitments respectively. Please refer to Chart 1 for additional detail on geographic distribution.

**Chart 1. Geographic Breakdown as of 12/31/2008\***

Geography	Commitment Amount	%
California	\$ 1,112,812,152	48%
Illinois	354,027,397	16%
Tennessee	260,904,930	12%
New York	218,370,861	10%
Texas	150,863,014	7%
Michigan	100,000,000	4%
Vermont	64,051,416	3%

\* The Policy restrictions are based on total aggregate amount of \$10 billion. The percentages listed above are based on the portfolio outstanding amount.

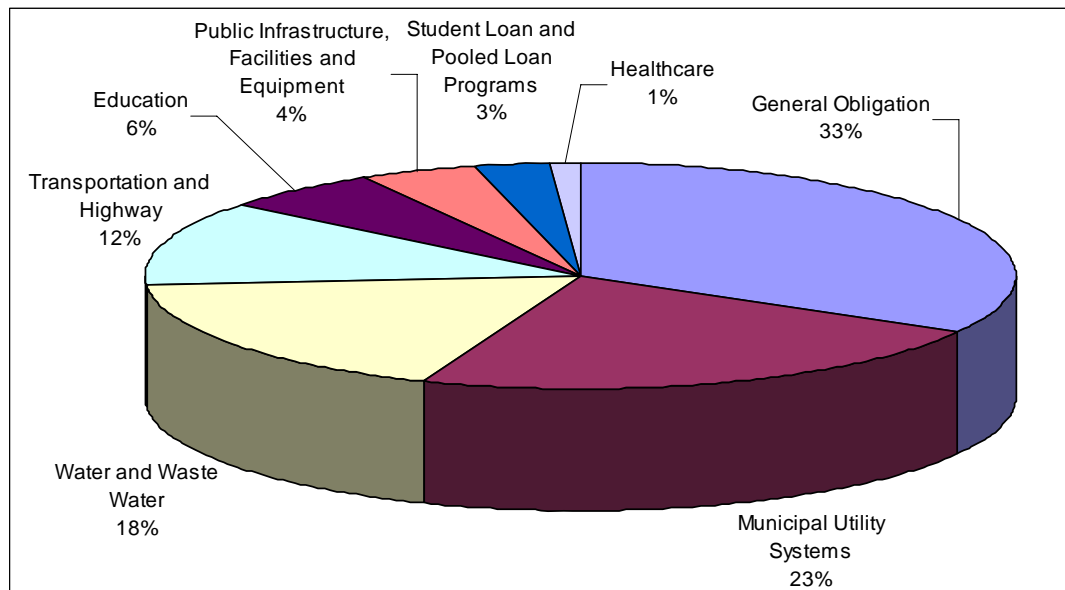


From a sector concentration perspective, 33% of the portfolio is concentrated in general obligation bonds backed by the full faith and credit of city, county, or state credits, 23% of the total commitment is in the municipal utility systems sector which includes power bonds and electric utilities. Staff has focused on high-quality essential municipal credits over the past year and has increased the allocation to the water and waste water sector as well as the transportation and highway sector. The increased allocation to water and waste water and transportation and highway since the last reporting period was \$400 million and \$280 million respectively. Please see chart 2 below for a detailed sector breakdown.

**Chart 2. Sector Breakdown as of 12/31/2008\***

<b>Market Sectors</b>	<b>Commitment Amount</b>	<b>Percentage</b>
<i>General Obligation</i>	760,005,564	33%
<i>Municipal Utility Systems</i>	510,128,767	23%
<i>Water and Waste Water</i>	395,827,982	18%
<i>Transportation and Highway</i>	279,794,521	12%
<i>Education</i>	126,914,063	6%
<i>Public Infrastructure, Facilities and Equipment</i>	100,000,000	4%
<i>Student Loan and Pooled Loan Programs</i>	64,051,416	3%
<i>Healthcare</i>	24,307,457	1%

\* The Policy restrictions are based on total aggregate amount of \$10 billion. The percentages listed above are based on the portfolio outstanding amount.



**Discussion:**

Given the setbacks created by the financial crisis, many credit enhancement participants have either scaled back or exited the credit enhancement market altogether. As a result, staff has seen a significant reduction in the supply of credit / liquidity facilities coupled with improvement in credit enhancement pricing.

***Decrease in Available Credit and Number of Financial Institutions Providing Credit*** – Many of our financial partners have exited the credit enhancement market altogether or scaled back in volume of deals done. As a result, staff has had difficulty finding partners and co-investors for many CEP transactions. Finding partners is even more difficult for California based transactions - an area which CalPERS CEP is limited by IRS Tax Code to taking a position of 25% or less on each transaction.

***Improved Pricing and Terms for Credit Providers*** - Due to the shortage of credit as described above, staff has seen a significant improvement in pricing and structural terms (i.e. covenants and documentation) compared to the previous reporting period.

***Deteriorating Credit Quality of the Municipal Borrowers*** - In addition to the constraints for issuers to access the credit markets, municipal credit fundamentals have also been challenged by lower than expected tax revenues due to the current economic downturn and rising budget deficits. According to a report published by Center on Budget and Policy Priorities in late December 2008, 44 out of 50 states have faced or will face budget shortfalls which will result in an estimated combined budget gap of \$350 billion for fiscal years 2009, 2010, and 2011.

Local governments will also be facing budgetary pressures. However, there are some key distinctions within local government. In an economic downturn, the rule of thumb is that city governments will weather the situation better than counties and other local agencies (i.e. school districts). The logic for this is that cities have the ability to increase revenue for services provided unlike counties and other local agencies who are almost always recipients of funds that flow down from the state level.

Although the credit quality of the municipal sector will continue to be stressed, the fundamentals of the underlying municipal transactions remain solid based on the issuers' ability to tax and raise fees and rates. Staff believes that the current downturn presents a favorable opportunity to offer needed credit enhancement capacity to municipalities nationwide. Over the next twelve months, staff will continue to focus its efforts on enhancing essential municipal credits with high underlying credit ratings.

**V. POLICY VIOLATION**

There have been no policy violations over the reporting period.

**VI. STRATEGIC PLAN:**

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

**VII. RESULTS/COSTS:**

The Credit Enhancement Program generated net earnings of \$3.9 million for the year ending December 31, 2008.

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